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ZERO BASE BUDGETING

**J.P. MITTAL
PRAMOD KUMAR**

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From Object Classification to Zero Base Budgeting

A STUDY OF DEVELOPMENTS

*Parimal Ray**

The Budget Story

Every organisation has its objectives and goals. But reaching those objectives and goals is possible only with the help of proper planning and execution of the plan economically. When management makes plans and expresses it in quantitative terms it is called a 'budget'.

The word 'budget' was first coined by the British Kings in early days to mean leather bag containing statements of their needs and resources expressed in quantitative and financial terms. Centuries later, the content itself i.e., those statements came to be popularly known as 'budget'. In 1215, the Magna Carta gave budgeting a political jolt and for the first time,

* Lecturer, Department of Commerce, Sivanath Sastri College, Calcutta.

budgeting got the constitutional exposure. The next important milestone in the history of budget was consolidated Fund Act of 1787. It considered, budget as a comprehensive financial statement of government activities for facilitating accountability of public fund. Budget entered the Parliament for the first time in 1822 seeking public advice and it remained confined there till the end of the 19th century with the following as its basic characteristics¹.

1. The word budget would use to mean Government Budget only.
2. On its expenditure side budget listed out specific authorisation by the government to various spending authorities for specific purposes.
3. There was no accrual accounting for budgeting; as such budget was structured on cash basis.
4. Expenditures under no circumstances could exceed the receipts in the government coffer. In other words, the budget was to be balanced. Balanced budget was considered a virtue which the government cherished.

Business Budget

The concept of budgeting in business first appeared in the United Kingdom in the 20th Century. Though business borrowed the term budget from the Government, nevertheless, because of the endemic ups and downs in business situations, the policy of preparing the budget by the government with fixed allocation was found inapt for it. The starting point for a business budget had, therefore, to be an assumption in regard to volume and mix with impact thereof on cost. Next embellishment to business budget came from Westing House Company of U.K. in the year 1928 when it classified business expenditures into three distinct categories with reference to their behaviour.

1. Y.P. Puri : Budgeting-Government, Business and Performance, Lok Udyog, B.P.E., New Delhi, Vol. VII, August, 1973, p. 9.

in response to the variations in the volume and mix. These classifications of costs were (a) engineered cost covering direct materials and other direct manufacturing expenses since with given product specification, engineers could figure out these costs with fair degree of accuracy, (b) committed costs representing the consequences of commitments made by the management in the past which do not respond at all to volume stimuli and (c) managed costs which depend upon the judgement and discretion of the management and which in the words of Professor Parkinson, tend to increase regardless of what happened to output.

In the sphere of business budget, right from the very beginning budget had object classification and based on experience, business houses gradually started preparing three types of budgets namely (a) operating budget showing planned operation of the enterprise for the forthcoming period, (b) cash budget expressing anticipated sources and application of cash and (c) capital budget showing planned changes in the fixed assets and considered as price list of presumably worthwhile projects for the acquisition of new capital assets over the budget period.²

Coming to the behavioral aspect of budget in the business, in theory, budget forms the basis for planning and coordination of the activities of an operating enterprise. Coordination has an implied concept of control innate with it. Control involves motivation and evaluation. Therefore, with every preparation of a budget by a business house, the assumption was that reports on actuals and comparison of the actuals with planned amounts would motivate the line management to produce efficiently and provide a basis to the top management for evaluating the effectiveness of the line management. Control was achieved by promoting the efficient and pulling up or replacing the inefficient. Therefore, it becomes obvious that budget to a business is not primarily an accounting device, rather a tool

2. R.N. Anthony : Management Accounting—Text and Cases, 3rd Ed.
Richard D. Irwin Inc., Homewood, Illinois, pp. 392-409.

of management especially for motivation since by approving budget estimates, management in effect communicates to the supervisors that if they operate their departments in accordance with the plan prepared with their participation, they would do what is considered good job. For it must be realised that no organisation can be conceived without having a goal and through the attainment of this goal those who work under it also attain the individual goals which need not necessarily be homogeneous in character.

An object classification budget cannot effectively serve the purpose for which the same is adopted as a managerial tool. This inability of the object classification budget arises partly from the mechanism by which such budget is prepared and partly from the technique of evaluation of performance of those who are responsible for practical implementation of the budget policies. It needs hardly be pointed out that object classification budget is practically an outcome of the exercise of the higher echelon of management brought together through a committee known as budget committee. Plan of action contemplated therein, in reality, is a command from the top rather than being a proposal from the grass root level. Another significant aspect with this type of budget is that under this method, unless difficulties are faced, budget allocations are taken as sanctions for free spending in the sense that there is hardly any attempt to correlate the output as against the financial resource input. In the allocation of resources also the basis becomes last year's provision plus percentage increase over the same based on previous trend. Therefore, if inefficiency creeps in, it perpetuates. In the circumstances, it is no wonder that traditional object classification budget would fail as an effective managerial tool.

Performance Budgeting

A process of rethinking on the efficacy of object classification budget in the sphere of government started from 1950s in the United States. It was found that since the great depression

of 1930s Government of Public spendings had been assuming increasingly larger proportions. What became a matter of concern was that such spendings continued unabated even when contra cyclical fiscal policy principles did not indicate it.³ This queer phenomenon led to the seeking of ways and means of linking output to input, that is, performance as against the use of resources as input in the programmes of Government or Public spending. From this obsession of linking outputs to inputs what ultimately emerged got the epithes of Performance Budgeting. It involved setting up of budget accounts in such a manner as to make available the cost of carrying out a function, programme or activity. Efficiency and economy is expected to come through the measurement of performance with reference to a standard and corrections of deviations where the same are called for. The essential steps that such a concept of budgeting call for are, to put in brief, as follows :

- (1) Clearly laying down corporate objectives in the context of environment both within and outside the business units.
- (2) Formulation of long-term plans for achieving those objectives.
- (3) Chalking out of short-term performance plans or budgets fitting into the long-term plans.
- (4) Planning of organisation and systems providing for a systematic drive for the achievement of the plans at minimum cost.
- (5) Enunciation of policy decisions and the procedures to make them effective with a view to ensuring that actions taken in different parts of the organisation are consistent with the overall plan and policies.
- (6) Delegation of powers for carrying out the assigned responsibilities.

3. S.K. Chakraborty, *New Perspective in Management Accounting*, The macmillon Company of India Limited, Calcutta (1979 Ed.) p. 349.

- (7) Introduction of action oriented and timely reporting system for monitoring progress and for considering and correcting deviations from the plan.
- (8) Using performance for playing a decisive part in determining the future career of each functionary.⁴

In the performance budget, it will be noticed that there was a shift from what is 'spent' to what is 'achieved'. Nevertheless, it could not score cent percent as a managerial tool as it did not introduce a budget making process involving men working at the grass root level with those who are in the uppermost strata of management. This deficiency in the performance Budgeting, even though it was considered as an improvement over Traditional object classification budgeting, explains the development of a new concept under the banner "Zero Base Budgeting."

Zero Base Budgeting

The seed idea of the concept of Zero Base Budgeting (ZBB) actually originated in the hands of an English budget authority, E. Hilton, as early as 1924 when he suggested re-justifying budget demands every year.⁵

The idea was brought into prominence under the epithet of "Zero Base Budgeting" in the early 1970s, initially through the writings of Peter A. Pyhrr of Texas instruments in which organisation it was introduced in 1969. Though in the State sphere, the U.S. Department of Agriculture had gone for it in 1960s it was soon abandoned as the venture did not prove itself quite successful. In 1972, however, the State of Georgia again adopted the concept of ZBB because of the keen interest which Mr. Jimmy Carter, the then Governor of the State, had

4. Y.P. Passi : Performance Budgeting, Lok Udyog, B.P.E. New Delhi, Vol. IV, August, 1970, p. 549.

5. A.S. Raj—Zero Base Budgeting, The Chartered Accountant, Journal of the Institute of Chartered Accountants of India, New Delhi, Vol. XXXIV, February, 1986, p. 632.

evinced for the same. The Federal Government of USA introduced ZBB in 1977 when Mr. Carter was the President of the United States.⁶

In India, the concept of ZBB has gained the attention of the academicians and those closely connected with the industries after Mr. V.P. Singh, the Union Finance Minister, had told in a meeting of the consultative committee of the members of the Parliament attached to his ministry in November, 1985 that Government of India would be switching over to Zero Base Budgeting from 1987-88 and the preparatory exercise for the same would be undertaken in 1986 87.

The ZBB Concept

Zero Base Budgeting concept demands that the budgeting process should start from scratch or zero meaning thereby each budgeted item of expenditure should be justified before inclusion of it in the budget proposal regardless of what has been spent in previous budget period. This justification must come from the person making the budget proposal who, ultimately, will be held responsible for execution of the plan proposed by him within the budgeted means. Under ZBB, there is a continuous appraisal of the activities absolutely needed for the organisation so that they have to be provided with within the limited funds available to the organisation. The most intricate task under the concept is to ascertain the activities which were at one time considered as very important to the organisation but now no more useful so that these can be omitted for inclusion in the forthcoming budget. The essence in ZBB is that each budget request must be backed by the reason for it without any reference to the level of previous appropriation.

6. J.L. Brown and L.R. Howard—Managerial Accounting and Finance, Macdonald and Evans Ltd., London (E.L.B.S. 4th Ed.). 1982, pp. 294-296.

ZBB Process

Effective and efficient application of ZBB system needs its development by pursuing the following steps :

(1) *Identification of decision units :*

A decision unit is a discrete activity for which a budget request is made. It may be either a group of activities or a particular project or programme. It is essential for ZBB that decision units are identified. There is no standard rule regarding the size of a decision unit. Irrespective of size what is essential is that there must be one identifiable manager who could be made responsible for preparing the budget for his decision units. It is not necessary that one manager should be in charge of one decision unit.

(2) *Preparation of decision packages :*

After the decision units have been identified, the manager of each decision unit is to analyse the activities of his decision unit or units with reference to the following queries :

- (i) What are the functions of department ?
- (ii) Is there any function or task which is now performed in the department due to some abnormal situation such as expansion or consolidation of facilities ?
- (iii) Is there any scope to eliminate or to reduce in future any task that is now performed in the decision unit ?
- (iv) Does the decision unit take service from any other department which can be dispensed with in future ?
- (v) What is the minimum staff required for the accomplishment of the normal function of the decision unit ?
- (vi) If the staffing exceeds the minimum required, what are the increments that must be approved or eliminated ?

On the basis of answers received to these queries, the manager would then have to locate those activities which are being performed at present within his decision unit but are of no use in fulfilling the objectives of the business. The first duty of the manager under ZBB system would be to recommend to the top management for the abandonment of such activities. The activities of the decision unit would then comprise only those which are necessary to the business either at their present level or any an increased level or at a reduced level. Once this has been done, the next step would be the formulation of decision packages.

A decision package is defined as a brief document that identifies and describes each decision unit in such a manner that the management can evaluate the programme proposed and the benefits of funding the programme. It mainly contains the information regarding activities to be performed or services to be rendered if the package is funded, total resource requirement of the package, benefits and results expected from it and lastly, an evaluation of all the effects of changes if the package is funded.

Generally there are three types of decision packages namely, (a) mutually exclusive decision package, (b) minimum level decision package and (c) incremental decision package.

A mutually exclusive decision package services to identify the alternative means of performing a function since the current method of operation is not necessarily the best one. The alternative found best by this process is recommended by the manager which is accepted and approved.

A minimum level decision package is an exercise to decide the minimum amount of activities and the minimum level of funding below which it is not feasible to continue the decision unit for constructive contribution towards fulfilling its objectives. This is otherwise known as the basic requirement of the decision unit the determination of which is not always an easy task. When the work is of routine nature, standard

measurement technique can be applied. But when the requirements of the job call for peak loads whose frequency, volume and timing are unpredictable, more subjective judgements are required.

An incremental decision package is made up of additional level of activities and concomitant additional funding for a decision unit once the minimum level decision package has been developed for it.

(3) *Ranking of decision packages :*

After the decision packages have been developed, the next step involved is the ranking of the decision packages. The decision packages are ranked in order of decreasing benefits to organisational decision units and these are forwarded to the upper level of management for review. For reducing the burden on top management, the managers at the successively higher levels review ranking with lower level decision-unit managers. After that a consolidated ranking of all decision packages is presented to the top management for review.

(4) *Allocation of organisational resources and preparations of detailed budget :*

Allocation of organisational resources and preparation of detailed budget happens to be the last step in the ZBB system. Once the top management has a consolidated ranking of decision packages, a cut-off point is then established for accepting packages based on available funds. All packages within the fund ceiling are accepted, the others are rejected. After allocation of resources to the decision units the decision unit budget is prepared by totalling all the decision packages which have been approved for that unit. Sumtotal of the allocation of funds for decision packages in different decision units then forms the overall authorisation of spending for the organisation in the budget year.

Where ZBB can be applied

ZBB, it has to be noted, cannot be applied to all costs

and functions in an organisation on a general basis. Its applicability has to be selective. Really speaking ZBB can be effectively tried only to those costs in an organisation that are discretionary* in nature. To speak more candidly, engineered costs and committed costs cannot be useful areas for its application. Functionally speaking staffs areas like marketing finance, administration, public relation etc. are most suited for its adoption. For, these are the areas where discretionary cost is maximum. The line areas like production function in a manufacturing organisation where input-output relationship is constant are out of its purview.

It can be applied both to industry and government and also to non-profit making organisations. In each case, however, the format of ZBB has to be tailored according to the requirements of the organisations where the same is to be introduced.

Excellence of ZBB

The success of ZBB depends upon a host of factors. The most important among them is that the top management must be willing to use this technique and must provide the support needed for its implementation. That is, executives at each level must wed themselves to this technique and assure their lower level managers that in-depth review of the activities does not pose any threat to their jobs.

Secondly, the top management will also have to explain the decision package concept and ranking process to all budget unit managers as well as issue a set of assumptions or guidelines on the activity levels, wage and salary increases and other

* Discretionary costs are those fixed costs (i) that arise from periodic, normally, yearly appropriation decisions regarding the maximum amounts to be incurred and (ii) that do not have a demonstrable optimum relationship between inputs (as measured by cost) and output (as measured by revenue or other objectives). Examples of such costs are advertising, public relations, executive training, research and management consultancy services.

expected changes to the managers at lower levels so that they can formulate their decision packages with obvious support, opinion, suggestions of those who work under them. Thus, it will be noticed, there is a built-in force of motivation in the concept of Zero base budgeting which distinguishes and makes it superior from other two types of budgeting viz. object classification budgeting and performance budgeting.